Internal Revenue Service

memorandum

CC:TL-N-9855-87
Br4:GBFleming

date: 4 SEP 1987

to: [redacted], Southeast Region SE:[redacted]

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

To assist in preparation of respondent's briefs in the above-captioned case, we have coordinated with the Interpretative Division, Legislative and Regulations Division (L&R), and Corporate Tax Division regarding support for the Service's litigating position in this case. Copies of memoranda prepared by those Divisions are attached. This memorandum summarizes the principal arguments (as set forth in the attached memoranda) supporting the Service's litigating position.

ISSUE

Whether [redacted] that is produced as a by-product of an [redacted] should be treated as a separate [redacted] mineral for purposes of [redacted] under I.R.C. § [redacted](b)(1).

DISCUSSION

The Service takes the position in this litigation that the [redacted] of [redacted] extracted as a by-product from the effluent of [redacted] is governed by I.R.C. § [redacted]A, as for any other product of an [redacted]. Therefore, in the Service's view, such [redacted] should not be eligible for the generally higher percentage depletion rate for [redacted] specified in section [redacted](b)(1).

The Service's position is supported, in the first instance, by the plain language and general framework of the Code and regulations. Section [redacted](b) explicitly excludes "[redacted]" from the term "[redacted]," and section [redacted]A similarly governs the [redacted] of "[redacted]." The choice of "[redacted]" rather than simply "[redacted]" supports the view that all production for an [redacted]

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[redacted] is subject to the [redacted] rate for [redacted]. In addition, although there is no statutory definition of [redacted], section [redacted]A(e)(2) defines "[redacted]" to mean "any product (other than crude oil) of an oil or [redacted]." (emphasis added) Thus, the structure of the Code provisions governing [redacted] appears to mandate that a by-product (such as [redacted]) extracted from [redacted] production is entitled to the [redacted] rate rather than any other [redacted] rate specified in section [redacted](b).

This result is consistent with the regulations for [redacted]. Under Treas. Reg. § [redacted], the gross income from the property for [redacted] is the amount for which the production is sold in the immediate vicinity of the [redacted]. Where, as in this case, the taxpayer does not sell the production in the immediate vicinity of the [redacted] but transports and processes it before sale, the gross income from the property is determined based on the representative market or field price of [redacted] of like kind and grade at the [redacted]. Treas. Reg. § [redacted] and (c). Under this rule, the gross income from the property for [redacted] is based on the value of the [redacted] or [redacted] in the immediate vicinity of the [redacted], before it undergoes any processing to remove the [redacted]. See Shamrock Oil & Gas Corp. v. Commissioner, 35 T.C. 979 (1961), aff'd, 346 F.2d 377 (5th Cir.), cert. denied, 382 U.S. 892 (1965).

[redacted] argues that the production should be treated as coming from [redacted], an [redacted] and a [redacted]. As pointed out in the memorandum prepared by L&R, there is no authority for this [redacted] theory. The previously noted definition of "[redacted]" in section [redacted]A(e)(2) seems to intend that all depletable products from an [redacted] will be subject to the [redacted] rules. As discussed in the Interpretative Division's memorandum, the legislative history of section [redacted]A indicates that Congress intended to reduce what it perceived as excessive tax benefits enjoyed by the [redacted] industry. Section [redacted]A narrowly limits the availability of the percentage depletion allowance for [redacted] to such an extent that certain taxpayers no longer qualify for the allowance. The [redacted] theory would permit taxpayers who do not qualify under section [redacted] for [redacted] with respect to [redacted] to receive a [redacted] allowance under [redacted](b)(1) for [redacted] extracted from such [redacted]. Adopting the [redacted] theory would, therefore, arguably circumvent the congressional intent underlying section [redacted] to reduce the tax benefits enjoyed by the [redacted] industry. The [redacted] theory would also be

inconsistent with the rules set forth in Treas. Reg. § 1.[redacted]-3, under which a [redacted] is treated as a [redacted], with its depletable income determined at the [redacted].

Aside from the lack of legal support for the [redacted] theory, treating the [redacted] as coming from a [redacted] would result in added administrative complexity. As discussed in the memorandum prepared by the Corporate Tax Division, such items as [redacted]. In addition, the [redacted] approach would raise novel questions regarding which processes in the extraction of [redacted] are considered mining processes and whether the portion of the intangible [redacted] costs allocable to [redacted] could be expensed.

While we believe that the enclosed memoranda will be of assistance in preparing the briefs in this case, we stand ready to provide whatever additional assistance you may deem appropriate. Please contact Gerald Fleming at 566-3305 if you have any questions or if we can be of any further assistance.

ROBERT P. RUWE
Director

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Attachments:
Memorandum from Corporate Tax Division
Memorandum from Interpretative Division
Memorandum from Legislation & Regulation Division